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UNCLAS SECTION 01 OF 02 PRETORIA 001506

SIPDIS

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E.O. 12958: N/A
TAGS: ECON EINV EFIN ETRD BEXP KTDB PGOV SF
SUBJECT: SOUTH AFRICA'S SURPRISE INTEREST RATE CUT

¶1. Summary. On April 14, the South African Reserve Bank (SARB) announced a 50 basis point reduction in its repurchase rate (equivalent to the U.S. federal funds rate) much to the surprise of South African economic analysts. SARB's justifications for reducing rates include lower inflationary expectations, signs of weakness in the manufacturing sector, and a benign inflationary outlook over the next year. The rand closed at 6.25, compared to 6.13 rands per dollar just before the SARB announcement, as the real interest rate differential between the United States and South Africa slipped to 4.65 from 5.15 percentage points. Tito Mboweni, SARB's governor, reiterated the bank's goal of inflation targeting rather than exchange rate or growth targeting. Dropping interest rates now might signal SARB's growing concern about sustaining South African growth in the midst of a strong exchange rate. End Summary.

SURPRISE INTEREST RATE CUT

¶2. The South African Reserve Bank's (SARB) Monetary Policy Committee reduced interest rates by 50 basis points bringing the repurchase rate down to 7 percent, the lowest level since 2000. Major banks followed with announcements that they would also reduce their prime lending rates from 11 percent to 10.5 percent. Real interest rates in South Africa are now 4.40 percent (i.e., the repurchase rate minus February's consumer price inflation of 2.6 percent). The real interest rate differential between the United States and South Africa narrowed to 4.65 compared to 5.15 percentage points before SARB's announcement. The reduction of the spread between real interest rates helps explain the overnight depreciation of the rand via the dollar.

Lower Inflation and Weakness in Manufacturing

¶3. In explaining the interest rate cut, Mboweni noted evidence of slower economic activity in the manufacturing sector as a result of the move by the rand to a higher trading range over the past six months. In addition, he cited recent evidence of slowing inflation and inflationary expectations. The latest inflation expectations survey conducted by the Bureau for Economic Research (BER) at the University of Stellenbosch showed a significant decline in inflation expectations. According to the survey, CPIX inflation (consumer prices less mortgages) expectations reached their lowest level since the BER started the survey in 2000. For the first time, survey respondents expected inflation to fall below the upper end of the 3-6 percent inflation target band. On average, CPIX inflation is expected to be at 4.5 per cent, down from 5.5 per cent in the previous survey. CPIX inflation is also expected to remain within the target range for the next 3 years.

Immediate Reaction

¶4. The reduction in interest rates took most analysts by surprise, as a Reuters poll of 15 economists done last week predicted that the SARB would keep the repurchase rate at 7.50 percent for the remainder of the year, with any rise in 2006 limited to less than 50 basis points. Standard Bank economist Monica Ambrosi asserted that key inflation risk factors, such as the outlook for oil prices and exchange rates, were more uncertain now compared to February, when the majority of economists were expecting a central bank interest rate reduction. The Council of South African Trade Unions (COSATU) called for additional interest rate reductions to weaken the rand and welcomed Mboweni's announcement.

SARB CONCERNS ABOUT SUSTAINABLE GROWTH

¶5. Comment. The unexpected rate cut may signal that the

SARB is increasingly worried about the detrimental impact of the strong rand on employment. Significant job cuts have been announced in the mining and textile industries, citing high rand costs of production. Recent deceleration of growth in the manufacturing sector is also of particular concern, as the manufacturing sector accounted for 17 percent of real gross domestic product in 2004. Manufacturing production growth sharply decelerated from December 2004's 7.9 percent growth to 3.2 and 2.7 percent in January and February 2005, respectively. Despite dim prospects for manufactured exports, production still increased over the past year due to robust domestic consumer demand. Real domestic expenditures increased 6.3 percent in 2004. End comment.

FRAZER